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RESEARCH ARTICLE

Xi Jinping's "New Normal": Quo Vadis?

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Abstract Xi Jinping, the most powerful new leader of China since Deng Xiaoping, has proceeded with a new agenda of economic reform, deleveraging, and the rectification of corruption; at the same time he has been intent upon sustaining high growth. This he calls China's "new normal." Beginning with an analysis of the old normal, we analyze the political economy of Xi's multifaceted approach and its contradictory consequences.

Keywords Rerorm · Corruption · Rebalancing · Leverage · Debt

China's "new normal" has been coined to refer to the slower but ostensibly higher-quality growth rate that the country has experienced since 2010, in order to downsize popular expectations after three decades of double-digit growth while maintaining performance legitimacy. The term (and the reality to which it refers) was coined by Xi Jinping, who has elevated himself to the positions of chief secretary of the Communist Party, chair of the central military commission (and its state counterpart), chief of state, chair of the newly created Committee on Deepening Reform and the National Security Commission and altogether 12 leading small groups. In China's Caesero-Papist system he also inherits the right to redefine the nation's guiding ideology, introducing such shibboleths as the "China Dream." A "princeling" scion of China's revolutionary aristocracy, Xi rose from a blameless but inconspicuous background as a provincial official without signaling his future intentions, prudently keeping his political agenda under wraps. Belying early expectations of political reform, Xi has rather since his ascension prioritized implementation of a sweeping anti-corruption campaign. But he also introduced a raft of economic reforms at the Third Plenum of the 18th Congress. The combination of elite rectification

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and economic reform he has endorsed is motivated by outsize ambition–to realize the "great revitalization of the Chinese nation." Yet it has also become clear since November 2012 that China faces some serious problems, the full dimensions of which were perhaps not initially recognized.

This paper is a preliminary attempt to assess that effort and its future prospects. Of course the future is something no one knows; to try to keep speculation under control, I presume the future will resemble the recent past, caeteris paribus, particularly the period since the 12th Congress. The first part of the paper thus reviews the past as a baseline for extrapolation. The second part analyzes some of the apparent inconsistencies that have emerged thus far in the ongoing implementation of the reforms. Based on this discussion, the third part of the paper attempts to anticipate the future.

Hu Jintao's Legacy

In order to understand where China is going with its new normal, we first need to see where it is coming from. Despite the Tiananmen "incident," the Party-State that Xi ascended was far more firmly institutionalized than the shambles Deng Xiaoping inherited from the Cultural Revolution. His smooth ascension was relatively unmarred by factional strife (*pace* Bo Xilai, which did not involve him) and the apparatus was united in proud defense of the solid achievements of the reform era, in 2010 highlighted by surpassing Japan's GDP to become second largest economy in the world. Amid admitted disappointment among some over reform's "lost decade" of reform under Hu Jintao and Wen Jiabao, their tenure boasted the nation's most rapid sustained average annual GDP growth since the early Great Leap Forward, while the fact that China came through the Global Financial Crisis that tipped most developed economies into prolonged recession without a single year of negative growth convinced many that the Beijing model was superior to the Washington Consensus. [1] Yet the leadership was aware that the 2009 stimulus package (which was repeated in smaller scale in 2012) was not an option of choice but a costly response to serious economic problems. The popular and elite expectations that greeted Xi's rise were hence mixed, as were the resources he had on hand to fulfil his plans.

In the aftermath of Tiananmen China found itself surrounded by Western nations jubilant about the disintegration of the Soviet bloc and looking forward to the expected collapse of the PRC. Economic GDP growth plummeted in 1989 and1990, exacerbated by Western economic sanctions [6].

In 1991–1992, many of the leading reformers having been purged, a reverse current arose within the leadership arguing that reform was a dangerous ideological deviation and demanding a return to socialist orthodoxy [27]. But Deng Xiaoping in his famous Southern Voyage [*nanxun*] curtailed the discussion of "isms," arguing that the country's troubles (and those of the former Soviet Union) had been caused by too little and too slow reform rather than too much. He pushed many of the conservative elders

[1] At the time Hu Jintao and Wen Jiabao came to power in 2003 China had sustained economic growth averaging 9.6% per annum for the previous 24 years, but Chinese GDP growth then accelerated, averaging 10.4% per annum for the next decade. [7].

who had supported his crackdown back into retirement and instigated the 14th Party Congress to endorse a "socialist market economy" as the goal of reform. The Chinese people were encouraged to "dive into the sea" [*xia hai]* of economic transformation and avoid further political experiments. "Opening to the outside world" was pushed hard to overcome Western sanctions as China expanded SEZ rules to the whole of China and liberalized its investment regime to facilitate more incoming FDI. Foreign policy priorities shifted to developing countries and particularly to China's Asian neighbors to circumvent Western sanctions. Zhu Rongji was promoted to vice premier, then premier to lead the reform effort. The economy responded with rapid growth and double-digit inflation, brought under control by tight money and a temporary slowdown induced by the Asian Financial Crisis by the end of the decade.

The 1990s can be generally characterized as political/administrative recentralization (from "one down" to "two down" for central appointments, return to CCP *nomenklatura* recruitments) combined with economic liberalization, the latter accelerating toward the end of the decade in preparation for China's bid for WTO membership. Jiang introduced "three represents" to permit private entrepreneurs and other useful "new class" elites to enter the Party. Financial coordination was centralized under four big central banks in 1993, the currency was devalued and a new central tax regime introduced in 1994 with its own administrative hierarchy, raising central revenue substantially.[2] Many of the township and village enterprises that had mushroomed in the 1980s to take advantage of rural reforms went into bankruptcy in 1995–1996, sparking a massive privatization drive, complemented by privatization of the hitherto state-owned urban housing sector. Albeit spared the financial fall that afflicted Thailand, Indonesia and South Korea, China was severely affected by a collapse of export markets in the Asian Financial Crisis and adopted expansionary fiscal and monetary policies to maintain an 8% growth rate, increasing the rate of fixed asset investment over consumption. The state-owned enterprise (SOE) sector had consistently underperformed, accumulating an unsustainable number of nonperforming loans, and Zhu Rongji undertook a major reform that involved setting up "asset management companies" to purchase and resell the NPLs and a program called "grasp the large, drop the small" [*zhua da, fang xiao*] designed to retain only the most efficient upstream firms as SOEs while encouraging the rest to merge or adopt various privatized corporate models. This provided a stimulus to private sector development, which mushroomed despite the government's economic recentralization efforts.

Following China's admission to the WTO in December 2001 significant changes were made in China's developmental model. The Hu Jintao-Wen Jiabao tandem both had career backgrounds in China's less developed provinces and represented a more neo-leftist approach to reform, focused on correcting the externalities of rapid GDP growth and redistributing benefits to those left behind. The new regime focused on the "Three Rural Issues" (*san nong*), agriculture, the countryside, and farmers, and implemented tax-for-fee (*fei gai shui*) reform in 2002 and abolished the thousand year old agricultural tax entirely in 2005, a bold move designed to equalize the yawning gap between rural and urban incomes; they also introduced China's first comprehensive national health insurance system (at a minimal level of coverage) and increased

[2] Chinese budget revenues as a percent of GDP increased from 10.8% in 1995 (US$113 billion) to 22.6% in 2012 (US$1.86 trillion) [23: 14–25].

spending on education and defense.[3] Because shrinking the state sector under Zhu had incurred popular opposition because of "management buyouts" (MBOs) and asset stripping[4] it was replaced by "SOE reform," with two main components: First, converting SOEs into share-holding corporations that sold stock in Shanghai, Hong Kong, or New York stock markets while retaining the state as majority share-holder (and management). Second, a major step toward revitalization of the state sector per se was taken in late 2006 with the State Council decision formally reserving certain "strategic" sectors of the economy for SOEs.[5] This enjoined nonstate firms from competing in strategic markets, while state firms were assured privileged access to loans, land, price-controlled inputs, and export subsidies. Under these circumstances the SOEs became profitable and vigorously expanded, pushing aside or merging with private competitors to dominate their respective sectors (and spilling over into other sectors as well, such as housing), inspiring the "*guo jin, min tui*" popular reversal of the officially endorsed slogan. While Chinese (and some Western) statistics show continuing growth of the private and corresponding diminution of the state-owned sector, the SOEs are larger than privately-owned firms and (as of 2015) still controlled over 50% of industrial assets and a somewhat smaller proportion of employment [19]. The sector has been profitable but increasingly noncompetitive internationally with a small and shrinking share of exports, particularly after the Global Financial Crisis (GFC). Yet the strategic industrial sector, ancestor of Lenin's "commanding heights" concept, retained a leading position in control of much of the upstream portion of the economy with excellent upside potential, favored for reasons of ideology, globalist ambitions and bureaucratic vested interests.

China's development in Hu-Wen era hence focused on strategic industrial command of domestic markets, vacating export markets to foreign-invested enterprises (FIEs) and a small but growing private sector. Given the strategic sector's position upstream this entailed an emphasis on heavy industry or fixed asset investment, especially infrastructure and construction, which expanded steadily through the 2000s. Housing was a particularly lucrative sideline because lacking attractive investment opportunities in overcapacity industries such as steel or cement, investment in housing created an inflationary bubble that continually raised the value of sunk investments.[6] The share of private consumption in GDP had by 2010 receded from ca 50% to 34% since the late 1990s; wage growth remained stagnant until the closing years of the decade. The infrastructure and construction achievement was indeed impressive: the world's largest high-speed rail network, the world's biggest output of steel, cement, solar panels, and a great many other products. The economy grew at its highest sustained rate since the beginning of reform. True, investment became increasingly inefficient because so much of it was wasted on products for which there was no market demand, thus total factor

[3] The 514 billion *yuan* [US$82.52 billion] spent on stability maintenance in 2009 was close to the 532.1 billion *yuan* [US$85.43 billion] in military expenditures that year. The 624.421 billion *yuan* [ca. $100.25 billion] for stability maintenance in 2011 surpassed the military budget of 601.1 billion *yuan* [US$96.51 billion] the same year, and has surpassed it ever since.

[4] The 2003 critique by Larry Xian-ping Lang [8], a finance professor at Chinese University of Hong Kong, brought the MBO issue into the critical spotlight.

[5] "The State should solely own, or have a majority share in, enterprises engaged in power generation and distribution, oil, petrochemicals and natural gas, telecom and armaments. The State must also have a controlling stake in the coal, aviation, and shipping industries" [32].

[6] Between 2003 and 2007, the average annual growth rate of real estate investment was over 25%.

productivity fell from 2007 to 2012, corporate debt started to climb and the incremental capital output ratio rose. In 2007 Wen Jiabao voiced his now famous complaint to reporters at the National People's Congress that "the biggest problem in China's economy is that the growth is unstable, imbalanced, uncoordinated and unsustainable … these are all pressing issues that need to be addressed as soon as possible or they will threaten China's economic growth … The government must boost domestic demand, open markets and promote technological innovation." [16]. But amid peak growth this minority viewpoint was ignored, as were Wen's recurrent calls for political reform.

The onset of the Global Financial Crisis in 2008 had an adverse impact analogous to the Asian Financial Crisis, but on a larger scale. China was not involved in American toxic debt as was much of the Western banking sector but export markets plunged, and as China had meanwhile become the world's biggest trading nation this plunged its export sector into crisis. Hence in late 2009 China launched a 4 trillion yuan (US$586 billion) stimulus package, the largest stimulus in the world proportionate to the economy. The stimulus package, widely lauded at the time as applied Keynesianism, focused on areas such as housing, rural infrastructure, transportation, health and education, environment, industry, disaster rebuilding, tax cuts, and finance. The short-term impact was to offset falling exports with domestic infrastructure investment, and it spared China from any single year of recession throughout the crisis period. The more worrisome consequence was to exacerbate all the problematic aspects of the previous decade: excessive infrastructure investment, housing bubble, pervasive industrial overcapacity. On top of all this was one new critical factor: the emergence of massive debt. This began with the stimulus package in the form of loans from the banking sector to SOEs–but this was only the beginning. From 2008 to 2013 loan growth averaged nearly 20% per year, more than double GDP growth. This amounted to nearly US$9 trillion in new loans issued by the banks. In 2015 total debts of all sorts increased by an amount equal to 12% of the economy, according to PBOC figs. [3]. Private wealth in contrast increased only $5 trillion during this period, according to a Credit Suisse estimate.

Xi Jinping

This was then the situation that Xi inherited when he assumed power in 2012: the highest growth record yet capping an unprecedented three decade run, rising expectations among the masses, ending however with a global crash that China survived only by incurring a massive debt load. And as the economy started to slow down each year after 2010, debt has continued to increase faster than GDP growth, both to pay down ongoing projects and to cover debt service costs. The impact of the crash and the subsequent bailout and growing debt was to exacerbate the trend since the early 1990s to increase the relative size and power of the SOE sector. The leadership encouraged this both for ideological reasons and because they hoped to make these into national champions in the global market. China also launched an indigenous innovation campaign in support of the SOEs and became more restrictive about incoming FDI, which dropped from 6% of GDP at its peak to around 1% in 2015. Xi introduced an ambitious reform plan at the 3rd Plenum of the18th Congress in 2013, which aimed to provide a "decisive role for market forces" and at the same time ensure "the dominant role of

public ownership." These two goals are contradictory: if public enterprises continue to have a dominant role, and if they are hence protected for "strategic" reasons, the rule of market forces is curtailed. To put the argument of this paper in a nutshell, the combination of three things: the intrinsic contradiction between market logic and the priority commitment to the public economy, the economically distracting impact of the anti-corruption campaign, and the debt burden imposed by the GFC stimulus package which has since continued to mount—have severely constrained the impact of the economic reforms outlined at the 3rd Plenum. The second, more speculative part of the argument is that a combination of ideal and material interests is likely to lock this internally contradictory package in for the foreseeable future.

It has since 2012 become clear that Xi Jinping's obsession with monopolizing the levers of power is matched by formidable ambition. The reforms outlined at the 3rd Plenum of the 18th Congress identified three central aspects of the system in need of reform: cadre corruption and rent-seeking behavior, economic rebalancing, and marketization. This agenda was scheduled for accomplishment by 2020 (the centennial of the CPP), by which point the size of China's economy (in 2010) is once again to be doubled.

Corruption Xi's first and most consistently sustained policy focus has been his campaign against corruption, coinciding with an elite austerity drive. Though an early anti-corruption drive is typical in Chinese leadership successions, Xi's campaign has been unusually protracted and intensive, and has greatly enhanced his mass popularity (while no doubt eliciting a more mixed verdict from China's 51 million cadres). According to the Central Commission for Discipline Inspection (CCDI), since late 2012, 414,000 officials have been disciplined for corruption and 201,600 prosecuted in court. As of 2015, the campaign had 'netted' over 100 high-ranking officials, including about a dozen high-ranking military officers, several senior executives of state-owned companies, and four "big tigers" or national leaders; the campaign was notable in implicating both incumbent and retired national leaders, including former Politburo Standing Committee member Zhou Yongkang and former Central Military Commission officers Xu Caihou and Guo Boxong [1]. Some provinces have been particularly impacted: Shanxi, Sichuan, Guangdong, Jiangsu, for example. In Shanxi some 15,450 officials were convicted, an increase of 30% over 2013. In Hunan province 156 officials were disciplined or fired in 2014 for infractions including drinking or banqueting at work, gambling, lying, absenteeism, allowing factions to form among subordinates, using one's office for financial gain, and not responding to letters from the people [14]. By October 2016 the over a million officials had reportedly been disciplined by the campaign.

Perspectives vary about the campaign: it has been highly popular among the masses, who have so far not felt its sting. Supporters highly appreciate the prospects for wiping out the party officialdom's sense of entitlement and permanently transforming Chinese political culture, rehabilitating the CPC's reputation for purity and its moral mandate to rule. Others liken it to a sweeping quota-driven purge, with torture, 99% conviction rates, televised confessions, and suicides. Intellectuals object to the tendency to include Western thinking as a form of corruption, accompanied by a crackdown on netizens, human rights lawyers, artists and all manner of dissidents. It differs from Maoist campaigns in being tightly controlled by the Central Commission for Discipline Inspection (CCDI), an inner-Party secret police force, via the opaque, extra-judicial

shuanggui process, minimizing mass involvement [5, 31]. Thus it raises concern in the Chinese legal community, who fear collateral damage to the rule of law. The intended economic impact is of course to eliminate rent-seeking and cadre corruption and improve public morality. Whether the campaign has any such effect even in the short run is as yet unclear.[7] Assuming it has, there are two further questions. First, how long will the deterrent effect last once the campaign draws to a close? Aside from the strengthened role of the CCDI there have been no structural reforms designed to eliminate incentives or prevent corruption from recurring, only to punish it once it does. The second has to do with the functional utility of corruption—is it a tax on efficient production, or is it a lubricant making it possible to get things done? Thus far the drive has coincided with a decline in production, though correlation does not imply causation and there are other possible reasons for this. A causal linkage is at least demonstrable in sales of *maotai,* Swiss wrist watches, gambling receipts in Macau, and other such conspicuous consumption. But since the summer of 2015 there has also been a substantial increase in flight capital, estimated by Goldman Sachs at $500,000 in the first 9 months of 2016 alone.[8] The fact that corruption targets are secretively selected has given rise to suspicion that the process is politically motivated (for example, few "princelings" have been targeted, nor cadres from Zhejiang or Fujian, where Xi Jinping previously served), or that it has been used to root out vested interests and pave the way for Xi's reforms. Indeed, in 2014, over 70 senior executives of state-owned enterprises (SOEs) were investigated, covering the oil, iron, electricity, telecommunications, aviation and shipping industries [12]. In 2014 the Party began urging cadres to resign from their concurrent positions at these enterprises, and within two months over 40,700 officials had resigned or released from their roles in SOEs, including 229 officials at the provincial and ministerial level [30]. Particularly hard hit have been the petroleum industry and the State Assets Supervision and Administration Commission (SASAC), also a nest of political opponents. The FIE sector, though not subject to *shuanggui*, has not been exempt from attack. The British head of Chinese operations of Glaxo Smith Klein (GSK) was given a three year suspended sentence and deported to Britain, for example, and four Chinese GSK managers were found guilty and given suspended sentences. China's National Development and Reform Commission (NDRC) targeted both Daimler and Audi for monopolistic price gouging in auto parts under China's anti-monopoly law, after which the latter announced price cuts. Prosecuting foreign corruption has been highly popular. There has been some suspicion that the "permanent purge" has had an inhibiting effect on the other reforms however, whose progress since 2013 has been desultory (see below). Thus the leadership has made non-action a punishable offense, though this is difficult to prove.

Rebalancing The Chinese economy has been imbalanced in two ways, which are to some extent linked: the external balance (between exports and imports), and the internal

[7] The 2014 ranking of countries by the Corruption Perceptions Index actually ranked China lower than a year before, falling from 80th to 100th place [10]. Such statistics may however be premature and misleading; if corruption is measured in terms of convictions, the impact of a crackdown would be an perceived increase in corruption.

[8] In 2012, Chinese citizens comprised 1675 of the 10,000 annual quota of EB-5 visas allotted by the US State Department (contingent upon making a US$1 million investment providing jobs for 10 people). In 2014, that number rose to 8308.

balance (between investment and consumption). The external and internal imbalances are to some extent linked in the sense that rebalancing investment, the highest as a proportion of GDP in the world, and consumption (concomitantly very low) *could,* caeteris paribus, facilitate more imports (to meet rising consumer demand). Between 2000 and 2007, China's current account surplus surged from less than 2% to 10% of China's GDP. The rise in the current account surplus was accompanied by a sharp increase in the household saving rate (31% to 39% of household disposable income, most of which went into housing) and in the fixed asset investment share of GDP (33 to 40%). In the wake of China's fiscal stimulus in response to the GFC, the unusually large investment share of GDP expanded further, peaking at 47% in 2013. China's exports have risen steadily since 2001 with the exception of 2009, when they plunged in the wake of the GFC, until 2014, when they began to decline. Although exports declined after 2014, imports declined even more, leaving China with a consistent trade surplus. Thus China has remained an export-oriented growth economy. Nor has the internal imbalance been righted between consumption and investment. There have been some signals of a shift of emphasis since 2010, for example in 2015 expenditure on services first exceeded manufacturing at 50%, but much of that was for financial services, explicable in terms of that year's unusual gyrations of the stock market—if financial services are stripped out, relative spending priorities did not change. There is still strong institutional and ideological support for a positive current account balance and for the powerful SOEs seen to represent China's "comprehensive national power," which are also the main beneficiaries of overinvestment in fixed assets.

In March 2007, then-Premier Wen Jiabao highlighted the need to rebalance the Chinese economy away from an investment-led, export-driven economy toward a consumption-oriented economy. The government began to draft a plan for income distribution reform in 2004, and after nine years of consultation and study and half a dozen drafts, the State Council finally issued an opinion in February 2013 calling for an increase in the share of household income in the country's GDP and for wealth redistribution among groups and regions in the country.[9] Indeed, toward the end of the 2000s competition for workers began to drive up unskilled wages: by 2012, real wages for migrant workers were two and a half times what they had been in 2003, increasing by 10.8% annually. Demographic trends (i.e., the aging and shrinking work force) necessitate such adjustments—Naughton suggests that China has reached the Lewis turning point [22]. Yet all this has been dwarfed by the massive investment in infrastructure financed by the 4 trillion yuan stimulus package, and by the continued state expenditure on the public sector.[10] Tax revenue collection has remained over 20% of GDP and the central budget was left relatively unscathed by the debt crisis but the government has not since made any major fiscal infusions into welfare or pensions or health care or any other policies to raise household income and thus further boost consumption. While in 2006 investment was 40% of GDP and private consumption was 38.3%, by the end of 2015 investment stood at 45.3% of GDP and private

[9] Text in http://news.xinhuanet.com/politics/2013-02/05/c_114625358_2.htm, as cited in [29]

[10] China launched a large infrastructure investment plan in 2015 for altogether 323 infrastructure projects (high-speed railways, airports, highways, etc), including 131 in 2016, 92 in 2017, and 80 in 2018. Though unnoticed by the media, 2015 qualifies as a third fiscal stimulus, following 2009 (the biggest) and 2012.

consumption at 38.2%. Since Xi's rise, the rhetorical emphasis has also shifted away from the need to rebalance, while in practice any decline in GDP growth has tended to unleash lower interest rates and a relaxation of credit constraints.

The reason for the failure to rebalance from excessive investment to greater consumption is that in the short term any such rebalance entails a slowdown in growth, which generates elite anxiety about the consequences in terms of unemployment and mass unrest. Economic growth remains a leading criterion for cadre promotion, along with stability maintenance (*weiwen*)—but the two are empirically linked, because as growth declines unrest rises. China experienced a 13-fold increase in labor strikes and protest from 2011 to 2015; from 2014 to 2015 incidents doubled to reach 2500. The global economy has been slowing, from a peak of 14.2% growth in 2007 to 6.9% in 2015 (according to official statistics), and China's trade has declined with it. Export-led growth previously supplemented the domestic market with global demand but that has stalled and domestic demand has not picked up the slack. There are also ideological considerations. The SOEs still enjoy favor as the "commanding heights" and national champions of socialism with Chinese characteristics, and the Chinese have grown proud of this distinctive economic architecture with their "rise" and less impressed with US economic advice. The SOE sector is well entrenched in the party-state bureaucracy and has been resourceful in finding arguments to deny any need for structural change. The leadership seems to have shifted its focus from the need to rebalance to domestic consumption to various ideas to keep the investment and export sector moving ahead, such as the massive "one belt one road" projects, which seem designed at least in part to loan money to countries on China's periphery to launch massive projects similar to those China has built (for which they will hire Chinese infrastructure contractors and workers, if they accept Chinese loans). The leadership seems torn between accepting slower growth in order to deleverage and rebalance and doing whatever is necessary to maintain GDP growth above 6.5% and meet their growth target for 2020.

Rebalancing trade would be very popular among China's trade partners, who blame China for a global financial imbalance. But Chinese financial authorities view a positive balance of payments much more favorably, have maintained one since 2000 and prefer to continue; thus any change is not likely to result from official policy [17]. Since 1994 China maintained its trade surplus via "currency manipulation" (keeping the value of its currency lower than that of its trade partners while total factor productivity increased the value of its exports), but under pressure from the US China implemented a "crawling peg" beginning in 2005 that revalued the currency over time by about 20%, so the International Monetary Fund (IMF) in 2015 decreed that the yuan was only moderately undervalued, and in 2016 the Bank of China actually started using its foreign exchange surplus to increase the value of the renminbi. The trade imbalance is now maintained by excluding imports from the "strategic sector" reserved for pillar industries and by export subsidies and other perquisites for the SOEs. The economic rebalance the Xi leadership has in mind is from backward industries to higher value-added industries. In the words of top economic advisor Liu He: "For quite a long time China will have to rely on exports, but during that period [we have to] to position ourselves more favourably in the global market" [17]. The overall trade strategy is to maintain market share in developed economies and to expand vigorously in emerging economies. The Chinese see utility in clinging as long as possible to a dominant

position in labor-intensive exports as well, taking advantage of economies of scale to undercut local competition.[11]

The Market Markets have been the hallmark of reform since 1978, and the reform contingent within the leadership (including many of Xi's economic advisors in the Development Research Center, which prepared the policy draft behind the 60-item 3rd Plenum Decision) continue to try to steer policy in this direction. This commitment was manifest in the communique's pledge that markets should play a "decisive" [*jueding xing*] role in allocating resources, moving away from previous communiqué terminology which described this role as "basic." The communiqué also highlights "free flow of products and factors" and "fairness of resource allocation." This "decisive" role was however counterbalanced by the promise that "The Party must give full play to its core role of commanding the whole situation and coordinating the efforts of all quarters." In other words, the desire for market efficiency competes with the need for political control.

Inasmuch as making the market "decisive" is a very broad imperative, we turn to three key aspects of the economy to see what impact the proposed push toward market reform has had.

1. The SOE sector is at the heart of the existing bureaucratic capitalist structure, a natural target because an SOE is a hybrid between market rationality and *raison d'etat* and marketization would logically entail pushing the SOE away from the state and into the market. Despite being reformed to adopt corporate best practices in the late 1990s, SOEs are still owned by the state, managed by cadres appointed by the Central Committee Organization Department, and expected to serve certain nonmarket functions (such as employment). Despite enjoying political favor, including low interest rates, cheap land, lower tax rates and soft budget constraints, they have hitherto been less efficient in terms of return on assets than private or foreign owned firms, indeed some are chronic loss-makers ("zombies").[12] The regime response has waffled between privatization and moving to reinforce state ownership as a pillar of stability at home and increased influence abroad. The emphasis so far has been on the latter, particularly for the *yangqi* (central state firms) in strategic sectors. The immediate emphasis in 2013 was to require SOEs to pay 30% dividends to the state–but whether this is true reform or the state just reaching out for more revenue is unclear. According to a long-delayed "Guidance" put forth in September 2015, SOEs are to be opened to mixed ownership, allowing private capital to take minority stakes through strategic partnerships in protected SOEs [33]. For example, in 2014 Sinopec sold off about 30% of its retail business to private investors, raising more than 100 billion yuan [4]. But this "private" investor was actually a consortium of Chinese companies, most of which were also SOEs. In other words, SOEs are selling minority shares to other SOEs, potentially

[11] China is clinging to low-cost manufacturing, even as it goes upmarket to exploit higher-value activities. Its share of global clothing exports has actually risen, from 42.6% in 2011 to 43.1% in 2013. It is also making more of the things that go into its goods. The World Bank has found that the share of imported components in China's total exports has fallen from a peak of 60% in the mid-1990s to around 35% today

[12] Average return on assets for state companies was at about 4.6% in 2014, compared with 9.1% for private businesses [2].

leading to oligopolistic domination of the market by two or three *yangqi*–not to private investors.[13] Indeed why should the latter be interested in buying into SOEs, as state-owned assets cannot be sold below book value? Moreover, the government has warned against outflow of state-owned capital. The terms of sale in any case leave the state as majority shareholder with no change in the structure of voting rights. Thus the SOE benefits from an infusion of capital but not from a shift to more market-logical management. And senior managers of central SOEs still hold the equivalent of senior minister-level status (*fubuji*) in China's political system. Unlike the corporate reform of the late 1990s that forced thousands of SOEs to privatize and laid off some 40 million workers, the SOEs are not only left intact by the Guidance but strengthened to compete internationally. Beijing prides itself that in 2015, 98 Chinese firms were included in the Fortune Global 500 list. Why? Xi Jinping reportedly aims to mobilize big SOEs to realize his "one belt, one road" vision. China passed an antimonopoly law in August 2007, but state-sanctioned monopolies and SOE-dominated strategic sectors enjoy exemptions; it has chiefly been used against FIEs to protect local champions. The State Council's pledge in October 2015 to phase out price controls in nonstrategic sectors by 2017 could be an important step toward creating more competitive markets, but is unlikely to affect *yangqi* domination of these industries in the near term.

2. Market reform of the financial sector has had greater momentum than in any other sector, despite missteps contributing to the great 2015 stock market boom and bust. It is deemed necessary because the state banks have hitherto been partial to the least efficient SOE sector and it has been very difficult for private firms to obtain loans. This is one of the reasons for the explosion of the "shadow banking" sector, particularly after the GFC when the collapse of exports forced many to get loans to stay afloat. Private sector enterprise before 2007 was starved of funds, receiving only 20% of bank credit. China's financial system is still tilted toward the state-owned sector but there have been some recent efforts at reform. The head of the China Banking Regulatory Commission announced September 2014 that the first five private banks had been approved, though further details are as yet lacking.[14] The People's Bank of China (PBC) also scrapped the deposit interest rate ceiling in October 2015, about two years after having scrapped the lending interest rate floor, so interest rates are now theoretically free. But the PBC still sets "benchmark" lending rates, which have a determinative impact.

With regard to international finance, China has expressed interest in floating its exchange rate, partly in response to trade partner requests but also because Beijing has an interest in making the renminbi an international reserve currency. To this end currency swap centers have been established in Hong Kong, London and other global financial centers, and bilateral trade with Russia is by agreement conducted in local currencies. China's drive to have the renminbi included in the benchmark special drawing rights (SDR) basket of the IMF was approved in the fall of 2015, premised on making the yuan

[13] Some sectors—e.g., the internet connection industry, the airline industry, financial services—have been more open to private competition, usually at the lower end (e.g., low-cost short-route airline carriers). CITIC received major equity investment from private sources: two foreign companies have acquired around 20% of voting rights, making CITIC a trailblazer in the mixed ownership system [21].

[14] There are more than a hundred private banks in China, but the others receive equity investments from SOEs.

"freely usable" (all other SDR currencies float). Amid considerable market volatility in 2015 further progress toward capital account liberalization has however stalled for the time being. Free Trade Zones (FTZs) have been set up in Shanghai, Tientsin, and elsewhere to facilitate international financial transactions, although these have disappointed investors' hopes that this would be a step toward liberalization of the capital account or a national "negative list." Talks with the US toward a bilateral investment treaty (BIT) have continued since 2013.

3. The establishment of secure property rights has generally been deemed essential to a market, and despite the emancipation of peasants from communes in the household responsibility system (HRS) they have not had the same property rights as have urbanites. The 2013 CC Decision promises to give farmers the ability to mortgage their land leases in the HRS to obtain loans to move to the cities in the leadership's bold urbanization plan. Yet this program would deprive rural leaderships of their chief source of revenue since the abolition of agricultural taxes in 2005 (i.e., expropriate land at cut prices and sell it to developers), and is resisted on ideological grounds by the left, thus requires major legislative action (perhaps even constitutional amendment) to move forward. As part of the same program the government promised to work on granting urban residency permits and access to "basic urban public services" to around 200 million rural migrants currently working in the cities (of 500,000 inhabitants and under) in the central and western regions of the country (not in the large eastern cities), also allowing children living with migrant workers access to urban education and expanding vocational training. Again, little progress is visible on a program that would require more funds to the cities to provide the promised amenities and to compensate the rural villages for revenue loss of the exiting migrants.

Debt China increased domestic indebtedness substantially with its 2009 stimulus package, the largest in the world proportionate to the size of the economy, and has continued to incur debt at about twice the rate of GDP growth since that time. Although there are various estimates, at the beginning of 2015 McKinsey put the total debt load at 282%, on which interest payments alone amount to 20% of GDP. One of the reasons debt has continued to mount is that more and more capital is required to service the debt, i.e., the "incremental capital output ratio" (ICOR) has doubled since 2007. As of 2015, George Soros noted in 2016, it took seven units of credit to get one unit of growth [26]. Total factor productivity is declining. Who bears the debt? Sovereign debt is actually relatively low at 43.9% of GDP (2015). Private consumer debt is also low, at around 20% of GDP. At the same time, local governments have seen their debt rise to some 37.7% of GDP [18]. Chinese companies, both SOEs and private firms, have amassed the highest debt in the world, both in absolute terms and relative to GDP (in most developing countries, corporate debt averages between 40 and 70% of GDP). Chinese companies had an estimated US$1 trillion in foreign debts as of the end of 2014, or 158% of GDP. The informal "shadow banking" component ("local government financing vehicles" or LGFVs) led the expansion, growing at an estimated 37% annually since 2007. Based on Chinese central bank data, the Fung Institute put shadow banking assets a little over 50% of GDP in 2014, less than one-third the size of bank

credit. This sector magnifies the risk as well as the credit burden because it makes loans at higher interest rates with less collateral. Though China is not unique in accumulating an unsustainable debt load there are two features that make it particularly dangerous: the speed at which the debt has been contracted, and the limited capacity of the debtors (local governments and industries) to repay [23]. This combination has in past precedents generally precipitated financial crisis.

There was no mention of debt in the 3rd Plenum reform documents, but the problem has since grown to sap the momentum of the economic reform program. It is a problem of liquidity rather than solvency, for after all with a foreign exchange cache of over US$3 trillion the government could simply refinance the banks to roll over the loans, as it did via Asset Management Corporations after the Asian Financial Crisis (AFC). But the center does not wish to do this. The cumulative debt is first of all much larger—larger in proportion to the economy than Japan's when the asset bubble burst in 1991. The crackdown on corruption makes moral hazard an issue, and an infusion of fresh cash might also touch off inflation. But more importantly it would exacerbate the problems of asset bubbles and overcapacity and further reduce capital efficiency. Hence the center has been trying to deleverage by striking a balance between maintaining the officially targeted 6.5% GDP growth minimum (set by the 13th Five-Year Plan in March 2016) and enforcing fiscal probity by limiting new loans to credit-worthy projects. Thus far the center has avoided a crash and forestalled an epidemic of bankruptcies but its commitment to fiscal rectitude has been repeatedly sidetracked by the need for more credit to avoid growth stalling. Thus in October 2014 the central government prohibited the shadow banking sector from taking new loans, but in May 2015 the authorities relaxed controls on the ability of local governments to raise money by allowing them to tap government-sponsored financing companies. According to this directive, LGFVs may continue to get loans from banks to fund ongoing projects. If local firms have trouble repaying their bank debts, their loan contracts should be "renegotiated and extended." Another financial innovation has been to permit local authorities to package their debt into long-term bonds. Thus as growth slows, the reform thrust gives way to the old priority on GDP growth at all cost and the debt burden escalates faster than growth. The leadership has not relinquished its conviction that CCP legitimacy is performance based and that unless a growth rate sufficient to ensure full employment is retained social instability will ensue.

The Future

Xi Jinping inherited an economic system that had been setting global growth records for more than three decades, having rebounded from the Tiananmen crisis and subsequent international ostracism, triumphantly surviving both the AFC and the GFC. In the second decade of the new century the dynamo began to slow down. The economic model had become burdened with a public sector less efficient and less profitable than the private sector despite numerous reform attempts. The capitalist global economy almost derailed China's export sector with the GFC, leaving the economy with a mounting debt burden. Yet Xi was determined to launch the nation toward still loftier goals approaching the symbolic centennials of 2021 and 2049, reaching for the Chinese Dream, an inspiring synthesis of capitalism and communism. So far, the reform and

rectification effort has however fallen short in two senses: first, the 3rd Plenum reforms have not been fully implemented; and second, they have not stimulated growth. Recent reports indicate that the economy has been stabilized and the decline in growth rates arrested at around 6.7% (still impressive comparatively), not by reform but by providing more investment credit. The economy remains "unbalanced, unstable, uncoordinated and unsustainable." In the political arena the Xi leadership's solution to rising levels of unrest has been not to open new or revitalize old channels of popular accountability but to popularize neo-Confucian moralism and reinforce mechanisms of censorship and repression. The leadership of Xi Jinping has become increasingly personalized and monocratic.

These developments have been profoundly disappointing to advocates of reform in China and elsewhere, prompting a spate of analysis and prescriptions [15, 20, 25, 28]. The thrust of much of this literature is that the old China model based on exports and fixed asset investments and repressed consumption has run out of steam, China needs to rebalance and fundamentally restructure its political-economic system. Political liberalization is necessary, not necessarily democratization in the Western sense with multiple parties and full electoral sovereignty, but one that at least allows for educational enlightenment in the school system and open channels for popular feedback and redress; otherwise repressed discontent is apt to explode unpredictably and chaotically. The economy should be rebalanced, both externally and internally: Externally, the recent tendency toward "reform and closing-up" [11] should be arrested, the country that has benefited more from globalization than any other should open its market and balance its foreign trade. The capital account should be opened and the currency exchange rate floated. The debt load is a drag on the economy that must be faced and deleveraged, even at the cost of a temporary drop in GDP growth. The internal imbalance should be corrected by eliminating financial repression, constructing a more adequate social security and pension net, instituting minimum wages, by investing in alternate energy, and by privatizing the SOE sector.

There seems to be a quite prevalent school of thought among Western China watchers, if not a consensus, that the recentralizing growth model China has pursued since the early 1990s has exhausted its potential and that the reforms outlined above would be both better attuned to the slackening global economy and in the long-term interest of the PRC [13]. Gradual political liberalization, if carefully managed, could further strengthen the regime's legitimacy and foster a domestic climate more hospitable to innovation. Reopening the economy would help eliminate the global imbalance that has emerged since the AFC as well by rebalancing international trade and current accounts. Balancing the domestic economy by redirecting fiscal policy from fixed asset investment to social security and health care and raising salaries would draw down the current account surplus and restore the ratio between consumption and investment that existed before 2000. This would be a huge bonanza both for light industry in China and for China's trade partners. Privatizing the SOE sector would make these firms more efficient and competitive and turn their income stream from the state where they contribute to investment in industrial overcapacity back into the economy, particularly services and the more labor-intensive SME (small and medium enterprise) sector. This would reduce rising income inequality as well, a product of China's investment and export-led growth model.

Based implicitly on the validity of this model of economic analysis, it seems logical to infer not only that the policy prescriptions derived from the model are correct but that China's leadership is perforce following them. In other words, there is a tendency for normative assumptions to be smuggled into the analysis of empirical reality. This takes the form of "as China rebalances its export growth-led economy…" as if this transformation is logical and hence proceeding, albeit perhaps more slowly than one might have wished. But if the analysis above is correct, this model is actually not being pursued, at least not yet. Little or no political reform has been visible since 2012. The anti-corruption campaign has taken on a life of its own and is still forging ahead, with CDIC offices now being established at provincial and local levels. But the reforms announced at the 3rd Plenum have made little progress. Of course there could be personnel changes at the 19th Congress in 2017 that could instill new life into the reform effort. Perhaps Xi Jinping is waiting to consolidate his power after his senior Politburo Standing Committee colleagues step down, as five are scheduled to do. Such are the types of wishes that also anticipated the 18th Party Congress. But how realistic are they?

Such speculations are based on certain psychological assumptions. Xi Jinping has not pushed reform because he is weak and profoundly uncertain about his hold on power, only after eliminating his senior colleagues and possible rivals will he have the confidence to proceed vigorously. China is after all plagued by serious problems: high pollution rates, unsustainable debt, declining growth rates, American pivot, growing popular unrest, and so forth. For this supposition to be correct, we must image a paranoid Xi Jinping for which little empirical evidence can be found. Xi does not appear from his observed behavior in office to be afflicted by a crippling lack of confidence. Since his ascension in 2012 he has surprised all onlookers with his strong and quick grasp of more power than his predecessors disposed of so early in their terms. And he has not been shied from launching an unprecedented anti-corruption campaign that many of his colleagues (e.g., Jiang Zemin) considered excessive and risky. When faced with an obstacle Xi's first instinct is not to hesitate or compromise, but to double down. Was the introduction of the sweeping belt and road scheme the notion of a timid or cautious leader? To all appearances, Xi has been both confident and vigorously effective–he has just not put a very high priority on reform.

So what reason to we have to expect that he will change course after the 19th Congress? The same factors that have motivated his efforts thus far will still be in play: the need to maintain a high growth rate, to maintain social stability, and to retain public support via an expansionist foreign policy and domestic censorship and repression. These policies have thus far rewarded Xi with high personal popularity and no serious political setbacks despite a slowing growth rate [9]. The campaign against corruption mates well with mass resentments of growing inequality and elite predation; it also functions as a preemptive deterrent against the congealing of factional opposition. Xi Jinping has thus formed an autocratic leadership position that, while not impregnable, will be very hard for anyone to contest. Moreover, the SOE and the export-oriented growth sectors (not the same thing) have strong institutionalized support in the central bureaucracy with a vested interest in self-protection. There is also what Max Weber called an "ideal interest" in identifying the public sector with socialism with "Chinese characteristics," and concomitant nationalist pride in preserving these sectors rather than privatizing them. Thus the regime is apt to continue to put its energy into various

schemes to improve their productivity and relative efficiency, and it is not inconceivable that it may even succeed to some extent. All of this fits well with the current tendency to seek to craft a distinct Chinese national identity rooted in hallowed ancient traditions, both domestically and in terms of a foreign policy more willing to defy the "rules-based international order" (i.e., the interests of the US "hegemon").

There have been two arguments against this forecast that are actually quite similar: the "middle-income trap" thesis and the "regression to the mean" hypothesis recently advanced by Summers and Pritchett [24]. The former posits that developing countries that achieve high early export-oriented growth "miracles" become trapped in extensive growth models and find themselves unable to shift to more sustainable consumption-based growth. Thus after early growth sprints, they typically "regress" to the mean international growth rate of 2 % or so. But neither of these models has been constructed specifically around the Chinese case. Both are addressed to newly-industrialized economies (NIEs) in general, a category which China is then assumed to fit. But is it not conceivable that China is "exceptional," not like other NIEs in certain relevant respects? Indeed, we submit that China may be deemed exceptional in at least three ways. First, the subjective will remains very strong in China. Chinese Leninism is a goal-rational system in which regime legitimacy is premised on inspiring collective performance, for which "catching up" has long been the ultimate touchstone. This determination has no doubt been rekindled by the rise of Xi, who by barring any prospect of political or cultural reform leaves the economy as the only field open to the Chinese people to realize their China Dream. And with a relatively low per capita income the Chinese people are still highly motivated. Second, the Chinese economic leadership has heretofore been highly competent at managing their economy, focusing narrowly on growth while relegating environmental damage, human rights abuses and other externalities to the periphery. Their pragmatic flexibility and economic acumen has enabled them to negotiate financial crises that derailed their middle-income peers (e.g., South Africa, Brazil, Russia). Third, the Chinese leadership has at its disposal more resources and tools than politicians in a liberal market economy. China's debt is very high but it is all internally financed, meaning there is no risk of the sudden withdrawal of foreign investments that precipitated the financial collapse of Thailand and Korea in the AFC. In China there is no difference between fiscal and monetary policy or between banking and monetary policy and little difference really between the public sector and the private sector. Despite the reforms of the past three decades, China still to a considerable extent has a command economy, which it has lately been moving to defend and expand. Thus although the days of double-digit growth are probably over, China can sustain an impressive growth rate longer than one might normally expect. And even in decline China is growing at least twice the pace of a US or EU in alleged recovery. Chinese exceptionalism may sustain Chinese growth well beyond the range of typical developing country growth miracles.

The argument here is that the future will evolve out of the currently existing reality. It may be unstable and unbalanced, but it is perhaps more sustainable for the short to medium term than Wen Jiabao imagined. The policy of balancing between deleveraging and promoting further investment in order to maintain GDP growth can be sustained for quite some time despite overcapacity and credit-inflated asset bubbles. GDP growth may continue to flag, but so long as unemployment remains reasonably low and living standards continue to rise the people will support

their leadership, and the regime can remain on course to reach its epochal collective goals in 2021 and 2049, while still retaining its distinctive, path-dependent “socialism with Chinese characteristics.”

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